

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Leach Analyst: Roger Lackey Bill Number: AB 2557
Related Bills: See Legislative History Telephone: 845-3627 Introduced Date: February 21, 2002
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Exclusion/Distribution From Scholarshare Trust

SUMMARY

This bill would allow distributions from a Scholarshare trust to be excluded from income tax.

PURPOSE OF THE BILL

According to the author's staff, the intent of this bill is to expand the current state tax incentive to encourage families to save for their children's college education through the Scholarshare Program.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective upon enactment and operative for any distribution made on or after January 1, 2002.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Federal law provides that distributions and earnings from a state tuition program are nontaxable to the contributor if the account meets specific criteria. In addition, the gross income of the contributor does not include earnings (at the time they are earned) under the program, and the gross income of the beneficiary does not include contributions to or earnings (at the time they are earned) under the program.

Under the 2001 Economic Growth & Tax Relief Reconciliation Act (EGTRRA), an exclusion from gross income is provided for distributions made in taxable years beginning after December 31, 2001, from qualified state tuition programs to the extent that the distribution is used to pay for qualified higher education expenses. This exclusion from gross income is extended to distributions from qualified tuition programs established and maintained by an entity other than a state (or agency or instrumentality thereof) for distributions made in taxable years after December 31, 2003. Please see Attachment A for an explanation of all changes to federal tax law regarding qualified state tuition programs that were enacted by EGTRRA.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Alan Hunter for GHG

04/12/02

Existing state law (Education Code) established the Golden State Scholarshare Trust. The Scholarshare Investment Board may enter into agreements with participants to make payments to the trust for the payment of qualified higher education expenses for a designated beneficiary to attend an institution of higher education.

State income tax law allows an exclusion from the gross income of a designated beneficiary for contributions to the California Golden Scholarshare program and tax-deferred treatment for earnings on those contributions, which approximates the federal law, by:

- (1) deferring from current taxation to the participant or beneficiary earnings from the trust at the time they are earned;
- (2) providing that distributions from the program in excess of amounts contributed (such as interest, dividends, or capital gains) would be included in the gross income of the designated beneficiary at the time the distributions are made; and
- (3) providing that the furnishing of education to a designated beneficiary is considered a distribution.

California law is in conformity with federal law as it read on January 1, 1998, relating to qualified tuition programs. California law has not conformed to the changes made to the Internal Revenue Code by the EGTRRA.

THIS BILL

This bill would enhance the tax benefits allowed under the California Golden Scholarshare program to permit distributions in excess of amounts contributed (such as interest, dividends, or capital gains) to be excluded from gross income.

Existing state law defines a "Participation agreement" to mean an agreement between a participant and the Scholarshare trust.

This bill would also delete certain provisions related to the distribution under a Scholarshare trust including:

- all Scholarshare trust accounts that an individual is a beneficiary of shall be treated as one account,
- all distributions during a taxable year are treated as one distribution,
- the value, income, and investment in the participation agreement is computed at the close of the calendar year in which the taxable year begins, and
- a contribution by any entity or by a state or local government agency for the benefit of the owner, employee of the entity, or a beneficiary that could be designated by the entity is included in the gross income of the entity or the employee in the year of the contribution.

Since this bill would also allow all distributions to be excluded from gross income the deletion of the above provisions would have no impact.

This bill would also delete provisions related to the change of beneficiaries who are included as a "member of the family." Identical provisions exist in federal law to which California law conforms. As a result, these deletions would not impact the department.

IMPLEMENTATION CONSIDERATIONS

Current law allows that any distribution or earning under a Scholarshare trust participant agreement is excludable from the gross income of a beneficiary or participant, except as otherwise provided. Since the "otherwise provided" provisions would be eliminated by this bill, any distribution or earning from a Scholarshare trust participant agreement would be excluded from gross income, even if it is a distribution to the contributor or the beneficiary. As a result, it is not clear whether the provision being added by this bill stating "any distribution under a Scholarshare trust participation agreement to a beneficiary, is not includable as gross income of that beneficiary" is necessary.

Once the implementation consideration is resolved, this bill would not significantly impact the department's programs and operations.

TECHNICAL CONSIDERATIONS

Amendment 1 is provided to correct a technical error.

LEGISLATIVE HISTORY

AB 1122 (Corbett, 2001/2002) would conform to all the pension provisions contained in the EGTRRA, in addition to other federal provisions. Presently, AB 1122 is in the Senate Appropriations Committee.

AB 1743 (Campbell, 2001/2002) would conform to all the pension provisions contained in the EGTRRA, in addition to other federal provisions. Presently, AB 1743 is in the Assembly Revenue and Taxation Committee.

SB 657 (Scott 2001/2002) would conform to all the pension provisions contained in the EGTRRA, in addition to other federal provisions. Presently, SB 657 is in the Assembly Appropriations Committee.

SB 1256 (Brulte 2001/2002) would conform to all the pension provisions contained in the EGTRRA, in addition to other federal provisions. Presently, SB 1256 is in the Senate Revenue and Taxation Committee.

AB 2095, Lempert (2000), with the same language contained in this bill, died in the Assembly Revenue and Taxation Committee; AB 26, Nation, (2001) with similar language as contained in this bill, is currently in the Assembly Revenue and Taxation Committee.

SB 1262, O'Connell (Stats. 1999, Ch. 664) made a number of technical changes to the California Golden State Scholarshare program under the Education Code, including making the Scholarshare Investment Board, which is chaired by the state Treasurer, responsible for administering the program instead of the Student Aid Commission.

AB 2797, Machado (Stats. 1998, Ch. 322), allows, by direct conformity to federal provisions, an exemption from state taxation of other states' qualified state tuition programs and tax deferred treatment of the earnings on contributions made to any other state's qualified state tuition program.

AB 530, Committee on Higher Education (Stats. 1997, Ch. 851), established the California Golden State Scholarshare program, which, in conformity with the federal qualified state tuition criteria, provided an exemption from state taxation for the Scholarshare program and tax deferred treatment of the earnings on contributions made to the Scholarshare program.

Federal Public Law 104-188 (1996), amended by Public Law 105-34 (1997), established an exemption from federal taxation for certain qualified state tuition programs (such as Scholarshare) with tax-deferred treatment of the earnings on contributions made to a qualified state tuition program.

PROGRAM BACKGROUND

Under the Golden State Scholarshare Trust, participants open an account on behalf of a designated beneficiary. The money contributed to the account is placed in a trust that will invest in special investment portfolios chosen by the participant, which are designed to meet the needs of differently aged beneficiaries and different kinds of investors. The program is designed so that earnings in a Scholarshare Account will grow on both a federal and a state tax-deferred basis until the beneficiary is ready to go to college. The funds in the account can be used to pay for qualified higher education expenses at any eligible post-secondary institution throughout the U.S. (and even some outside the U.S.) – including vocational schools.

The Scholarshare program offers four different ways for a participant to choose to invest their contributions. Three involve investments in a combination of stock, bond, and money market mutual funds. Investment returns for the equity-based options will fluctuate and are not guaranteed since the value of accounts invested in these options will go up and down. The fourth option allocates contributions to a guaranteed funding agreement that guarantees the Scholarshare Trust both a return of principal and a fixed minimum rate of return.

In addition, 42 states have established programs similar to California's Scholarshare program. An individual is free to set up their plan in the program that is most beneficial to them regardless of residence. Therefore, states are competing with one another for investment in their Scholarshare program. As a result, 23 states offer state income tax deductions for some or all of the contributions made by an individual. Of course, the individual must live or at least work in the state offering the deduction. California does not offer any similar type income tax deduction.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. Illinois, New York, and Michigan automatically conform to federal law. Therefore, these states are in conformity with the EGTRRA changes. Florida does not have a personal income tax. Massachusetts and Minnesota conform to the IRC with a specified date. Minnesota recently passed legislation to conform to EGTRRA.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses under the PIT Law.

Estimated Revenue Impact of AB 2557 As Introduced 2/21/02 [\$ In Millions]		
2002-03	2003-04	2004-05
minor loss	-\$1	-\$1

Minor loss is less than \$500,000. Estimates assume that any exclusions from gross income claimed under this bill that exceed qualified higher education expenses would not be significant due to penalties applicable at the federal level.

Revenue Discussion

The revenue impact of this bill would be determined by the amount of distributions from Scholarshare trusts, excluded from gross income under this bill, that would be otherwise included in gross income of the beneficiary, and the marginal tax rates of these taxpayers. Estimates were based on a proration factor of federal projections developed for the Economic Growth & Tax Relief Reconciliation Act of 2001. The proration factor of 1% was based on state-to-nation comparisons of adjusted gross income (12%) and average marginal tax rates of beneficiaries (7%). The two ratios are multiplied to derive a proration factor of approximately 1%.

Arguments/Policy Considerations

This bill would only alter the tax treatment of distributions from a Golden State Scholarshare Trust, and would not apply to distributions from similar trusts administered by other states. As such, this may be considered to be discriminatory on the basis that taxpayers with California source income would be compelled to invest in the Golden State Scholarshare Trust, a California state agency-administered program, in order to receive the exclusion of distributions from the beneficiary's income.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 2557
As Introduced February 21, 2002

AMENDMENT 1

On page 2, line 17, after "is not", strikeout "be"

Attachment A

Background Relating to State Tuition Programs and the Federal 2001 Economic Growth & Tax Relief Reconciliation Act (EGTRRA)

Law prior to EGTRRA

Section 529 of the Code provides tax-exempt status to “qualified state tuition programs,” meaning certain programs established and maintained by a state (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account (a “savings account plan”). The term “qualified higher education expenses” generally has the same meaning as does the term for purposes of education IRAs (as described above) and, thus, includes expenses for tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible educational institution, as well as certain room and board expenses for any period during which the student is at least a half-time student. An “eligible education institution” is defined the same for purposes of education IRAs (described above) and qualified state tuition programs.

No amount is included in the gross income of a contributor to, or a beneficiary of, a qualified state tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary are included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent receives a refund) are included in the contributor's gross income to the extent such amounts exceed contributions made on behalf of the beneficiary. Distributions from qualified state tuition programs are treated as representing a pro-rata share of the contributions and earnings in the account.

A qualified state tuition program is required to provide that purchases or contributions only be made in cash. Contributors and beneficiaries are not allowed to direct the investment of contributions to the program (or earnings thereon). The program is required to maintain a separate accounting for each designated beneficiary. A specified individual must be designated as the beneficiary at the commencement of participation in a qualified state tuition program (i.e., when contributions are first made to purchase an interest in such a program), unless interests in such a program are purchased by a state or local government or a tax-exempt charity described in section 501(c)(3) as part of a scholarship program operated by such government or charity under which beneficiaries to be named in the future will receive such interests as scholarships.

Special estate and gift tax rules apply to contributions made to and distributions made from qualified state tuition programs.

A transfer of credits (or other amounts) from one account benefiting one designated beneficiary to another account benefiting a different beneficiary is considered a distribution (as is a change in the designated beneficiary of an interest in a qualified state tuition program), unless the beneficiaries are members of the same family. For this purpose, the term "member of the family" means: (1) the spouse of the beneficiary; (2) a son or daughter of the beneficiary or a descendent of either; (3) a stepson or stepdaughter of the beneficiary; (4) a brother, sister, stepbrother or stepsister of the beneficiary; (5) the father or mother of the beneficiary or an ancestor of either; (6) a stepfather or stepmother of the beneficiary; (7) a son or daughter of a brother or sister of the beneficiary; (8) a brother or sister of the father or mother of the beneficiary; (9) a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the beneficiary; or (10) the spouse of any person described in (2)-(9). Earnings on an account may be refunded to a contributor or beneficiary, but the state or instrumentality must impose a more than de minimis monetary penalty unless the refund is (1) used for qualified higher education expenses of the beneficiary, (2) made on account of the death or disability of the beneficiary, (3) made on account of a scholarship received by the beneficiary, or (4) a rollover distribution.

To the extent that a distribution from a qualified state tuition program is used to pay for qualified tuition and related expenses (as defined in sec. 25A(f)(1)), the beneficiary (or another taxpayer claiming the beneficiary as a dependent) may claim the HOPE credit or Lifetime Learning credit with respect to such tuition and related expenses (assuming that the other requirements for claiming the HOPE credit or Lifetime Learning credit are satisfied and the modified AGI phase-out for those credits does not apply).

New Federal Law (IRC. Sec. 529)

Qualified tuition program

EGTRRA expands the definition of "qualified tuition program" to include certain prepaid tuition programs established and maintained by one or more eligible educational institutions (which may be private institutions) that satisfy the requirements under section 529 (other than the present-law state sponsorship rule). In the case of a qualified tuition program maintained by one or more private eligible educational institutions, persons are able to purchase tuition credits or certificates on behalf of a designated beneficiary (as set forth in sec. 529(b)(1)(A)(i)), but would not be able to make contributions to a savings account plan (as described in sec. 529(b)(1)(A)(ii)). Except to the extent provided in regulations, a tuition program maintained by a private institution is not treated as qualified unless it has received a ruling or determination from the IRS that the program satisfies applicable requirements.

EGTRRA provides that, in order for a tuition program of a private eligible education institution to be a qualified tuition program, assets of the program must be held in a trust created or organized in the United States for the exclusive benefit of designated beneficiaries who comply with the requirements under section 408(a)(2) and (5). Under these rules, the trustee must be a bank or other person who demonstrates that it will administer the trust in accordance with applicable requirements and the assets of the trust may not be commingled with other property except in a common trust fund or common investment fund.

EGTRRA repeals the present-law rule that a qualified state tuition program must impose a more than *de minimis* monetary penalty on any refund of earnings not used for qualified higher education expenses of the beneficiary (except in certain circumstances). Instead, EGTRRA imposes an additional 10% tax on the amount of a distribution from a qualified tuition plan that is includible in gross income (like the additional tax that applies to such distributions from education IRAs). The same exceptions that apply to the 10% additional tax with respect to education IRAs apply.

A special rule applies because the exclusion for earnings on distributions used for qualified higher education expenses does not apply to qualified tuition programs of private institutions until 2004. Under the special rule, the additional 10% tax does not apply to any payment in a taxable year beginning before January 1, 2004, which is includible in gross income but used for qualified higher education expenses. Thus, for example, the earnings portion of a distribution from a qualified tuition program of a private institution that is made in 2003 and that is used for qualified higher education expenses is not subject to the additional tax, even though the earnings portion is includible in gross income. Conforming the penalty to the education IRA provisions will make it easier for taxpayers to allocate expenses between the various education tax incentives. For example, under EGTRRA, a taxpayer who receives distributions from an education IRA and a qualified tuition program in the same year is required to allocate qualified expenses in order to determine the amount excludable from income. Other interactions between the various provisions also arise under the Act. For example, a taxpayer may need to know the amount excludable from income due to a distribution from a qualified tuition program in order to determine the amount of expenses eligible for the tuition deduction. It is expected that the Secretary will exercise the existing authority under sections 529(d) and 530(h) to require appropriate reporting, e.g., the amount of distributions and the earnings portions of distributions (taxable and nontaxable), to facilitate the provisions of the Act.

Exclusion from gross income

Under EGTRRA, an exclusion from gross income is provided for distributions made in taxable years beginning after December 31, 2001, from qualified state tuition programs to the extent that the distributions do not exceed qualified higher education expenses. This exclusion from gross income is extended to distributions from qualified tuition programs established and maintained by an entity other than a state (or agency or instrumentality thereof) for distributions made in taxable years after December 31, 2003.

Qualified higher education expenses

EGTRRA provides that, for purposes of the exclusion for distributions from qualified tuition plans, the maximum room and board allowance is the amount applicable to the student in calculating costs of attendance for federal financial aid programs under section 472 of the Higher Education Act of 1965, as in effect on June 7, 2001, or, in the case of a student living in housing owned or operated by an eligible educational institution, the actual amount charged the student by the educational institution for room and board. This definition also applies to distributions from education IRAs.

EGTRRA modifies the definition of qualified higher education expenses to include expenses of a special needs beneficiary that are necessary in connection with his or her enrollment or attendance at the eligible education institution. This definition also applies to distributions from education IRAs.

In addition, a special needs beneficiary would be defined as under the provisions relating to education IRAs, described above.

Coordination with HOPE and Lifetime Learning credits

EGTRRA allows a taxpayer to claim a HOPE credit or Lifetime Learning credit for a taxable year and to exclude from gross income amounts distributed (both the principal and the earnings portions) from a qualified tuition program on behalf of the same student as long as the distribution is not used for the same expenses for which a credit was claimed.

Rollovers for benefit of same beneficiary

EGTRRA provides that a transfer of credits (or other amounts) from one qualified tuition program for the benefit of a designated beneficiary to another qualified tuition program for the benefit of the same beneficiary is not considered a distribution. This rollover treatment does not apply to more than one transfer within any 12-month period with respect to the same beneficiary. The intent of this provision is to allow, for example, transfers between a prepaid tuition program and a savings program maintained by the same state and between a state plan and a private prepaid tuition program.

Member of family

EGTRRA provides that, for purposes of tax-free rollovers and changes of designated beneficiaries, a "member of the family" includes first cousins of the original beneficiary.

Effective Date

The EGTRRA provisions are effective for taxable years beginning after December 31, 2001, except that the exclusion from gross income for certain distributions from a qualified tuition program established and maintained by an entity other than a state (or agency or instrumentality thereof) is effective for taxable years beginning after December 31, 2003.